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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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APPRAISAL PERIOD. Readers who own historical charts of the Dow Jones daily price movements may note that subsequent to reactions in either bull or bear markets, it is not uncommon for a period of narrowing price fluctuations (on diminishing volume) to occur. On other occasions, definite "lines" may appear in the averages. Commenting on those periods of dullness which follow reactions, Hamilton observed that "...strong interests who supported the market (at the lows) to help out the weak holders, will distribute the stock which they were compelled to purchase. The future course of the market turns on its ability to absorb this stock." If the stock which is fed out on the rebound can be successfully digested by the market, then the next movement will be upward. If the market is unable to absorb the recovery offerings, however, there will be another decline which will usually violate the preceding lows.

During the past few weeks, while the two averages fluctuated within an extremely narrow range, the market has been subjected to an almost unprecedented variety of financial news; the steel strike, the pier strike, the advantages or disadvantages of a Taft-Hartley injunction, the tight money picture, the booming British stock market, the Chino-Russian talks, the new 5% Treasury notes, a torrent of bullish forecasts from corporate leaders -- and these tempered with a few dire predictions from bearish analysts. "The passionless market barometer", said Hamilton, "is disinterested because every sale and purchase which goes to make up its finding is interested. Its verdict is the balance of all the desires, compulsions and hopes of those who buy and sell stock." The market is and has been sifting the evidence. Its final decision will be the correct one -- yet all our impatience and worry will not hasten it.

I have heard many professionals scoff at the concept of the averages' being able to appraise the future well ahead of the nation's leading economists. Yet taking the long view, it is certain that the vision of the market has already proved superior to the financial "forecasts" which were so prevalent during the first eight months of 1959. While the "experts" painted glowing pictures of what "had to come" during 1959 and 1960, the market weighed the future with characteristic accuracy. October now finds the D-J industrials only 6% above their January, 1959 level, while rails are actually below their January quotations. It is for such reasons that Dow Theorists have learned to depend on the "bloodless verdict of the marketplace" while avoiding hopes, wishes and the pronouncements of "experts".

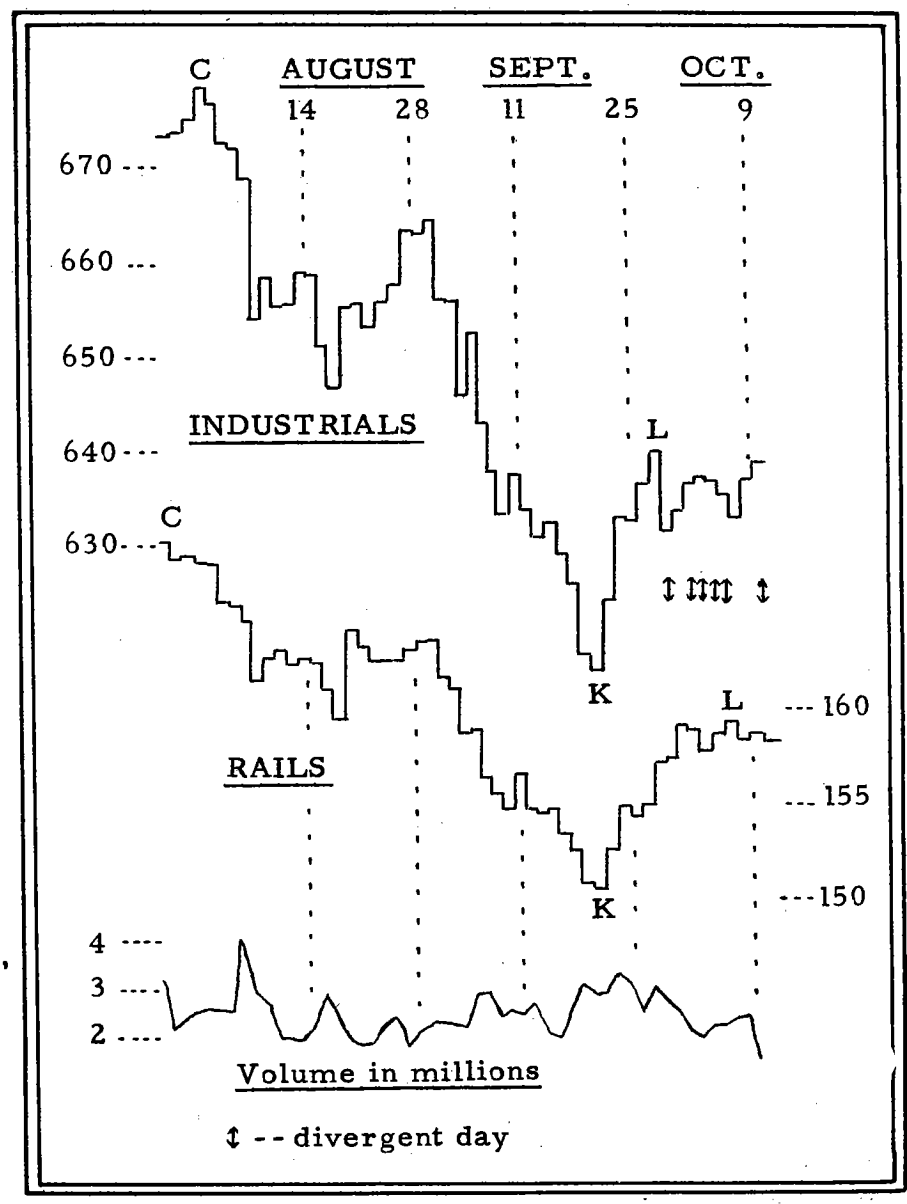
SECONDARY TERRITORY. As long as one or both averages remain under their July-August highs (industrials 678.10, rails 173.56) and above their K reaction lows (industrials 616.45, rails 150.28) the market will be fluctuating in what is termed "secondary territory". Price movements within secondary areas are generally more deceptive and difficult to interpret than any others encountered by market students. This is particularly true in secondaries which occur during the third (erratic) phase of a bull market. There have been

occasions in the past when the two averages traveled within secondary territory for months on end before providing a clear bull or bear signal -- a situation which can play havoc with the nerves of the most hardened investor.

PRICE MOVEMENTS. Following September 30th's industrial close of 640.10 (point L on industrials - see chart), the two averages diverged on five of the six succeeding days. Such divergence (the two averages moving in opposite directions) calls for caution, and a consistant "grinding of the gears" often precedes a violent rally or decline.

Since October 2, the two averages have formed minor "lines". Lines, readers may remember, are characterized by narrow price movements and are the result of very evenly matched buying and selling. A bettering of the L points (industrials 640.10, rails 159.34) would imply a new advance (perhaps a sharp one), particularly if volume expands on the penetration. In this event, the secondary trend would be up (see Letter 80), and the market would be in line for a further approach toward the highs. Even if the secondary trend turns up, however, the primary trend cannot be reaffirmed as bullish until both averages better their July-August highs.

Traders who buy stocks on a bettering of L will be speculating on an eventual move through the July-August highs. This is a valid "play", but should the averages falter and volume diminish on an advance above L, stocks bought in this area would have to be sold again. Having taken my profits (and a few losses) near the highs, I would not consider purchases executed on a bettering of the L points worth the risks involved. If, from any point under the July-August highs, the two averages turn down and violate the recent secondary reaction lows (the K points, industrials 616.45, rails 150.28) with heavy volume accompanying the penetration, the primary trend of the market will be taken as having turned from bull to bear. This would constitute a "sell everything" signal for Dow Theorists (see Letter 80, page 3).



QUESTION. "What about --- ----?" He calls himself a Dow Theorist, yet he says that when the steel strike is settled the economy will boom and the D-J industrials will go to 900. How can you both be Dow Theorists when you are cautious and he is so bullish?"

ANSWER. We will concede that William Hamilton, one of the founders of the Dow Theory, was also qualified to define the Thoery's usefulness. In October, 1921 Hamilton wrote, "It cannot too often be said that the stock market reflects absolutely all everybody knows about the business of the country." In 1922 he again observed, "...the stock market barometer does predict. It shows us what will happen to the general volume of business many months ahead."

If a new boom is to occur after the steel settlement, then unless the Dow Jones averages have ceased to function, they will discount the coming good news by advancing on increased volume and eventually bettering their July-August highs. The bullish implications of such a pattern would not be disputed by any student of Dow's Theory. On the other hand, any man who claims that a new boom must come following a steel settlement, and that the averages must therefore start advancing to discount that boom is suffering from "pride of opinion" or is completely ignorant of Dow's Theory.

Hamilton was well acquainted with all types of market "prophets", and he undoubtedly was referring to them when he wrote, "In the mind of the demogogue, Wall Street can never be forgiven for being right when he is wrong." In other words, the Dow Theorist follows the averages, whereas the prophet decides beforehand which way the averages must go. Should the market go against the prophet, he will denounce it as having "taken leave of its senses". I am perfectly willing to admit the possibility of an extension of the boom both in stocks and the economy. But since I attempt to follow the teachings of Dow, Hamilton and Rhea, I will also want to see evidence of the two averages heading for new highs before predicting a further boom.

SUNDRY OBSERVATIONS. In Letter 76 (August 24) I mentioned that U.S. Treasury competition in the already tightening short-term money market might generate a shift of funds out of savings institutions. According to last week's reports, savings deposits in 15 New York commercial banks dropped 45 million in the period of that one week. Federal Reserve officials call this drop almost without precedent, and there is little doubt that most of the 45 million switched to the 5% Treasury notes. It was estimated that the New York savings banks lost over 100 million of deposits to the Treasury during the same week.

Regarding this situation, Lawrence A. Epter, head of his own firm of mortgage correspondents, was quoted as follows:(N.Y. World Telegram & Sun, Oct. 9) "What must be understood is that the banks and savings institutions have been dealt a serious blow. These deposits were built up slowly over many years; they are not going to be regained overnight, or even over a period of months. In the meantime, the institutions will be forced to compete for deposits offering a much lower 'rate', and will have far less savings with which to buy mortgages. I'll make a guess that the Treasury by draining off 1 billion in small savings from these institutions has cost the nation at least 100,000 new homes in the next year, and a half million homes in the next five years." Mr. Epter did not mention that there will be many new Treasury note issues in the coming months.

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On October 9, the 91 day Treasury bills quietly hit a rate of 4.262%, a record high and one which was above the 4.25% registered in the 1933 bank holiday. When the steel strike ends, a surge of new pressures will undoubtedly hit the money market. This should give us some extremely interesting money rates.

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I do not suggest purchases of the new 5% Treasury notes (which are selling at a premium and therefore yield about 4.8%). I prefer liquidity, which means buying the 91 day bills. There's an old market adage which says, "Never speculate on the money rates". Those who buy the 5's (which mature in 4 years and 10 months) are betting that interest rates have seen their highs. I am not convinced. (Written - morning Oct. 12th)